OPINION

Internet Wars: Version 2.0

BY BIJAN KHEZRI AND HOWARD JONES

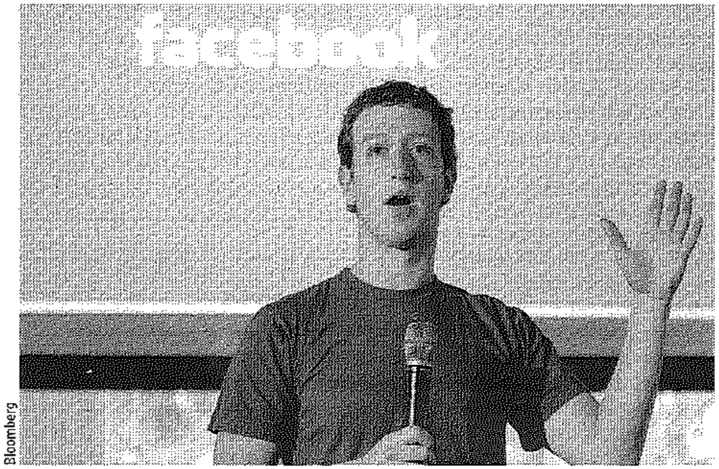
Is there another technology bubble in the making? This question has exercised the media and markets since the extraordinary post-IPO performance of LinkedIn, the social network for professionals. Social-sales aggregator Groupon has recently suggested that conventional valuation methods are obsolete and this has only reinforced parallels with the anything-goes internet IPOs of the early 2000s.

Social-networking firms are commanding hefty valuations, but investors must distinguish between social utility networks, like Facebook or LinkedIn, and the businesses that rely on them. The networks have the potential to exploit these businesses, distort the freedom of the Internet and stifle innovation. One relevant example has emerged within the social-gaming industry.

Social gaming is one of the most popular activities on social networks. Players connect and compete around a game through invitations, messaging and leaderboards. Sales of virtual in-game goods and advertisements are the primary source of revenues, which total more than $6 billion for the industry world-wide, a number expected to double by 2014. This year, Facebook is expected to generate more than $1 billion in gaming-related revenues, or more than 60% of its total expected revenue. Games benefit advertisers by providing them with a wealth of behavioral data. This produces more accurate consumer targeting based on gaming preferences, risk appetite and social profile.

Zynga has emerged as the undisputed leader in social gaming, with more than 230 million monthly users. It has an expected $20 billion IPO price tag, despite having only $28 million of net income in 2010. Yet Zynga displays many of the growth symptoms that conventionally spell trouble: frantic mergers-and-acquisition activity, offshore technology development, dependence on third-party technologies and infrastructure, aggressive litigation, and marketing spending growing faster than revenues. The risk here is an operational log-jam and an inability to innovate. However, it is Zynga's dependence on Facebook's infrastructure that deserves particular attention.

On July 18, Zynga filed an amendment to its IPO prospectus detailing its knotty relationship with Facebook. The two companies, who share some of the most powerful internet investors, have teamed up to dominate the burgeoning and highly lucrative social-gaming market. Zynga games that include Facebook integration or Facebook data will be exclusive to Facebook. In return, Facebook will help Zynga meet monthly unique user targets and share some of the revenues from ads sold next to Zynga games. Therefore the playing-field will be tilted against other game developers advertising on Facebook since they will partly finance Zynga.



Bloomberg

Facebook founder Mark Zuckerberg.

Zynga built up its market position at a time when Facebook had no restrictions on viral growth. Over the past year, Facebook has introduced limits on the sharing of contacts and invitations. Zynga's financial fire-power has also substantially increased the auction-based cost of advertising. The result is a social-gaming market with rising barriers to entry and a dominant market leader.

One enormous barrier is Facebook Credits, a proprietary Facebook currency, which skims 30% off of every sales transaction on Facebook. Zynga can comfortably absorb this charge but the levy may prove fatal for early-stage competitors. Yet companies and entertainers are likely to revolt if Facebook Credits become a device to monopolize the Internet and fortify Zynga's dominance.

The assumptions about e-commerce during the first Internet bubble turned out to be correct. But the market got ahead of itself. Today, the market is right to assume that social networking and social gaming will revolutionize consumer marketing, which explains their stratospheric valuations. But there are caveats: Investors need to look carefully at market structure to assess the prospects for individual companies.

In light of deals such as the one between Facebook and Zynga, the assumption of the Internet as a level playing field is at risk, though not all prospects are bleak. A previously undisclosed Zynga investor entered the social-networking market this July to announce that it may allow game developers to access the market openly and cost-effectively. Google, which has just launched its own social utility (Google+), may really be the company to watch. In its drive to challenge Facebook's dominance, Google is likely to redefine the balance of power between social utilities and business that rely on them. Today's competitive landscape is certain to change and valuation levels should take that carefully into account.

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